Palestinian National Authority

Ministry of Finance

Fiscal Developments

First Quarter 2010

May 9, 2010

Fiscal developments during the first quarter of 2010 (Q110)

1. Budget execution highlights during Q110

- **The current budget balance** of $ 307 million in Q110 is on track with the budget deficit target for 2010 of $ 1.24 billion
- **Gross revenues** increased by 35% in Q110 in NIS terms over revenues obtained in Q109, and are on target to exceed the $ 2 billion level for the first time, as projected in the budget.
- **Total expenditures and net lending** have fallen below the levels they had attained in Q409 and Q109, as most Gaza emergency expenditures have run their course. PNA public spending on an annual basis is running below budget targets for the full year by $ 90 million.
- **The wage bill** in Q110 is on track with the budget, except for a small overage (1.5%) due to the US dollar depreciation[1]. PNA employment increases have been kept within projected limits.
- **Non wage expenditures** of $ 280 million in Q110 are running substantially below, on an annual basis, budget targets for the year ($ 1.37 billion)
- **Net lending** of $ 71 million in Q110 is on a declining trend and on track to meet the ambitious budget target of $ 250 million
- **Development expenditures** of $ 56 million channeled through the Treasury in Q110, and mostly directed at

[1] Excluding one off items, see below.

community development projects, are on track towards the completion of another 1000 projects in 2010.

- **External budget support** of $ 208 million in Q110 fell short of the $ 300 million quarterly financing requirement from donor countries. This, coupled with very little development financing channeled through the Treasury ($ 2.2 million), compelled the PNA to increase its borrowing from banks ($ 98 million) and build up additional payment arrears ($ 68 million)

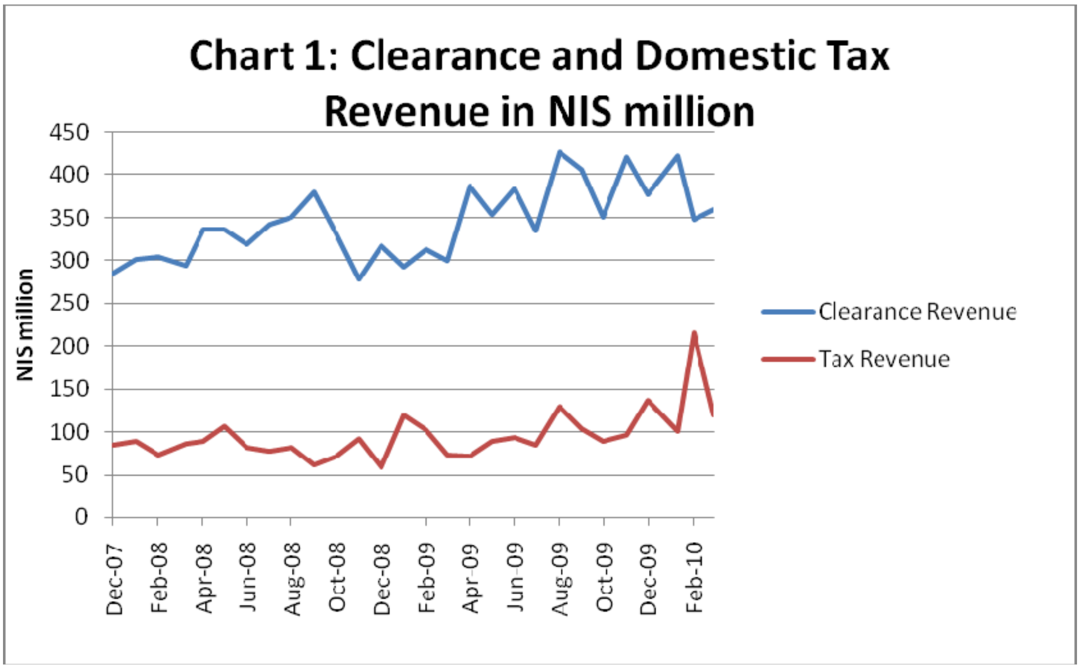
2. Revenue

Total gross revenue mobilized by the Palestinian authority during Q110, of $ 463 million increased by 35% over gross revenues collected during Q109 in NIS terms[2] (tables 1 and 5). Extrapolating this revenue mobilization to the full year 2010, by applying the economic growth assumed in the PNA 2010 budget (7%) to the revenue proceeds during the remaining three quarters, and by adding the projected dividend receipts ($ 55 million) expected before year end, we obtain $ 2.04 billion, or slightly above the 2010 budget target of $ 2.03 billion. Hence, revenues obtained in Q110 by the PNA, are in line with the budget target. Total net revenues of $ 440 million in Q110 are also in line with the annual budget projection of $ 1.93 billion, when factoring in expected growth and receipt of PIF dividends.

This strong revenue performance is mostly due to a large increase in domestic revenue, as a result of administrative reforms in the domestic tax departments. Domestic tax revenue of $ 117 million during Q110 increased by 54% over domestic tax revenue collected in Q109 (table 5 and Chart 1). Substantial revenue

[2] The US dollar depreciated by 7.8% when comparing the average exchange rate in Q110 (NIS/$ 3.73) to the average in Q109 (NIS/$ 4.04). Since all PNA revenues and expenditures are in NIS, comparisons across quarters must be conducted in NIS.

collection efforts were deployed by the income tax and VAT departments. Efforts at raising income tax revenues focused on enlarging the tax base, collecting payments in arrears, and systematically reviewing tax liabilities by the 100 largest corporations. Greater controls by custom officers have also raised VAT revenues.



Non tax revenue of $ 44 million during Q110, was at about the same level as in Q409, and registered only a 2% increase over Q109. License fees which would typically average $ 15 million per quarter were only $ 10 million in Q110. This revenue item tends to be volatile and the shortfall in revenues may simply indicate delays in license fee payments.

Clearance revenue, which account for two thirds of total PNA revenue, have also been doing well. At $ 303 million in Q110, they increased by 35 % over Q109 in NIS terms. This is partly due to a weakness in clearance revenue during Q109, following the Gaza offensive, which depressed fuel and other import shipments to Gaza, thereby lowering indirect tax receipts from the Strip below their historical trend.

However, their performance also reflects growth in economic activity since mid 2009, as indicated by monthly increases during Q110. Projecting clearance revenue collected during Q110 for the full year, assuming that the economic growth projected in the 2010 Budget will be realized, clearance revenue in 2010 would reach $ 1.326 billion, or slightly above the budget projection of $ 1.320.

Clearance revenue in March 2010 included $ 2.7 million in income tax payments from Palestinian workers working in Israel. These payments have become quite significant. In 2009 they amounted to $ 20 million or the equivalent of 25% of all domestic income tax proceeds in 2009[3].

On the other hand, NIS 18 million per month, continue to be withheld from clearance revenue, by court order, to meet possible litigation awards. It should be recalled that in 2009, NIS 216 million were withheld ($ 55 million). All in all, while the PNA was owed $ 303 million in clearance revenue for Q110, what was actually cashed in was $ 227 million, due to various deductions, including for water and electricity bills[4].

Tax refunds, on a commitment basis amounted to $ 23 million during Q110, at about the same level as in Q109, and in line with the annual projection of $ 100 million. However, on a cash basis, only $ 1.1 million was disbursed, due to the large shortfall in external budget support, and the high indebtedness to the banking system.

3. Expenditures

Total expenditures and net lending during Q110 at $ 747 million, on a commitment basis, fell by 13 % from the expenditure level in Q409 (or by $ 100 million, Tables 1 and 2). Measured against Q109, they were also lower by 14%. Overall, Q110 public spending, when projected on an annual basis, falls below the 2010 Budget forecast by about $ 90 million.

[3] Given the magnitude of these receipts, MoF intends to take them out of clearance revenue and include them in income tax receipts, in line with GFS practice.
[4] Deductions for utilities are added to Net Lending

Wage expenditure of $ 395 million in Q110 (table 1) increased by 8.6% over the wage bill in Q109, in NIS terms and excluding two one off disbursements[5]. The 4% cost of living allowance, agreed to with the civil service union, became effective on January 1st 2010, and was disbursed in the February payroll. Projecting the wage bill for the full year, excluding one off items, would exceed the budget appropriation by 1.5%, which is entirely due to the 1.8% depreciation of the US dollar relative to NIS (NIS 3.73/$ Q110 rate, relative to NIS 3.8/$ budget rate). Therefore the wage bill, by end Q110, has been in line with budget appropriations.

Wage expenditures in cash (table 3) of $ 373 million fell short of the commitment level by $ 22 million. Arrears were incurred on the disbursement of the danger allowance in February and on remitting the employee contributions to the Pension Fund, all due to shortfalls in external budget support and resulting liquidity shortages.

Employment in the PNA authority increased from 147,726 employees at end December 2009, to 149,580 employees by end March 2010, of which 86,144 are civil servants and the rest, security personnel. The increase in employment of 1,854 mostly went to civil servants (1,508), particularly new teachers who were hired contractually at the beginning of the school year (September, 2009) but only confirmed in the payroll in Q110.

Non wage expenditures at $ 280 million in Q110 were lower than in Q109 ($ 399 million) or in Q409 ($ 343 million) in every category (tables 1 and 2). This welcome decline marks the unwinding of the Gaza emergency expenditures and the resumption of a normal expenditure pattern. As can be seen from chart 2, non-wage spending peaked in March 2009 and declined thereafter. Yet, because of liquidity shortages, due to much lower external budget support than committed by the donors, about $ 19 million in payment arrears were incurred (table 4).

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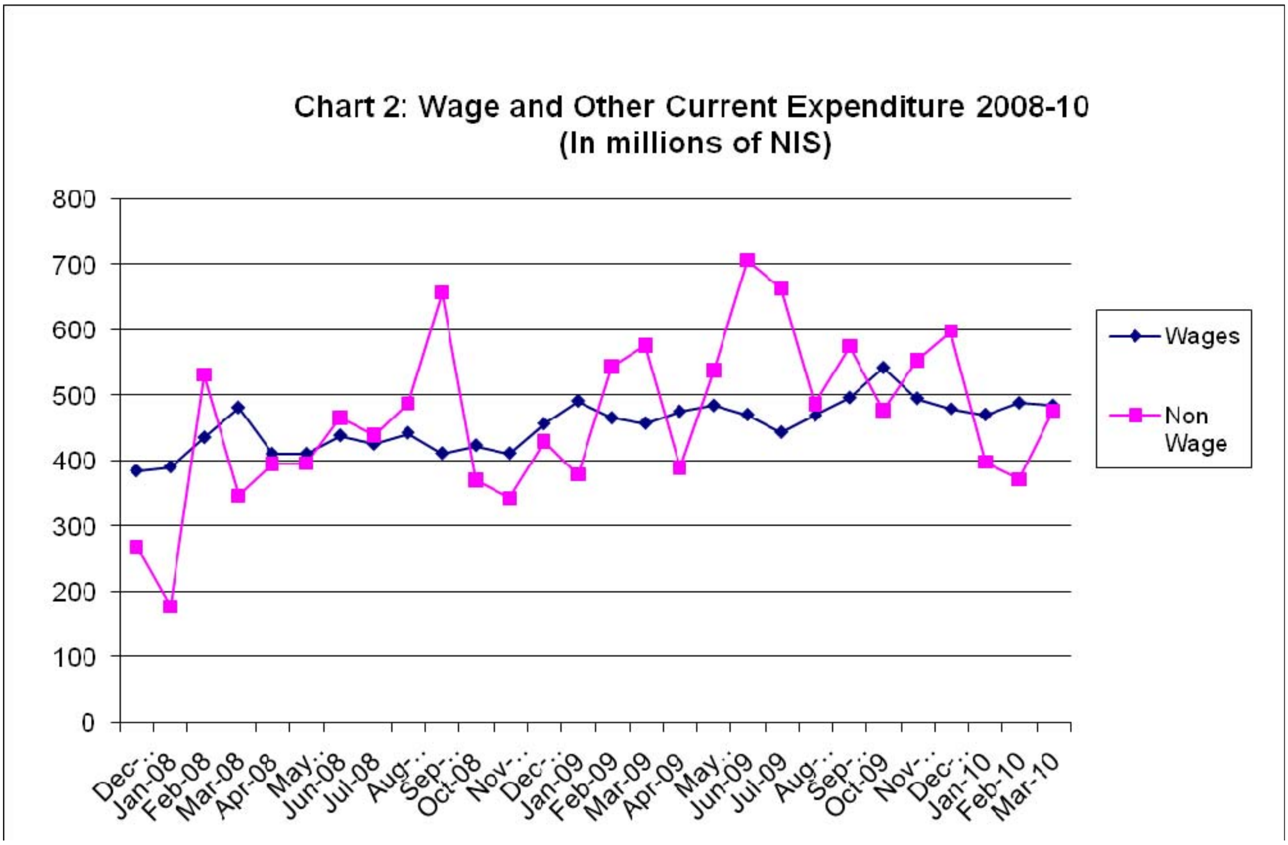
[5] Beginning January 2010, wage bill classification has been adjusted to GFS standards. Thus, transportation allowances have been shifted to operational expenditure while contractual employees payments, included in operational expenditures, were shifted to the wage bill. The January 2010 wage bill included a $ 2 million payment to the National Fund, which was due in December. In February, a danger allowance of $ 7.5 million was paid to health sector employees, retroactively to the beginning of 2009.



Projections of Q110 spending for the full year indicate that non wage spending may fall below budget appropriations by about $ 200 million. It should be noted however that transfers and operational spending tend to build up during the year.

Operational expenditures of $ 108 million during Q110 (table 2) fell by 24% from the Q409 level, partly due to a shift in classification of wages paid to contractual employees away from operational expenditures and into the wage bill. Nevertheless, operational expenditures declined by 21% from the Q109 emergency spending levels (on a comparable basis). The largest declines were in the health related expenditures (drugs and medical equipment) and in the emergency material which was procured for Gaza. Projecting operational spending on an annual basis, which now includes transportation allowances for PNA employees, would fall short of the budget appropriation by about $ 60 million.

Transfers of $ 170 million in Q110 were also lower than in Q409 ($ 206 million, table 2) and in Q109 ($ 234 million). However, most of the decline was due to lower compensation levels provided to the population impacted by the Gaza offensive and lower purchases of medical services. Projections of transfer spending for the full year indicate that it will be substantially lower than the budget appropriation.

There was a spike in transfers in March 2010 reaching $ 67 million, as opposed to an average of $ 52 million in January- February. This was essentially due to a World Bank transfer of social allowances in March amounting to $ 18 million.

Minor capital expenditures were very low during Q110, amounting to only $ 1.6 million, whereas the budget appropriation for the full year is $ 43 million. This is partly due to the liquidity shortage experienced during Q110 as a result of the shortfall in external budget support. It is also due to a prudent budgetary policy, restraining capital expenditures until a clearer picture on external financing emerges. It should be recalled that substantial spending took place in both 2008 and 2009 on office equipment and vehicles, exceeding budgetary appropriations due to accumulated payments arrears from earlier years. Since various ministries and agencies have already been well equipped, the pacing of current capital expenditures can be managed with some flexibility.

Net lending amounted to $ 71 million in Q110 (tables 1 and 2), marking a significant decline over the levels reached in Q409 ($101 million) and in Q109 ($ 76 million). It should be recalled that the budget appropriation for net lending in 2010 has been sharply reduced from $ 380 million in 2009 to $ 250 million in 2010, in the context of a policy aimed at eliminating net lending altogether. Thus, while an extrapolation of net lending expenses in Q110 on an annual level may indicate that the budget appropriation will be exceeded, net lending is on a declining trend, and MoF fully expects that the budget appropriation will be respected.

Strong collection efforts have been mobilized in West Bank municipalities, with a growing portion remitted to the PNA. In 2006, West Bank unpaid electricity bills passed on to the PNA Treasury amounted to $ 350 million. By end 2009, this

financial burden declined to $ 70 million. The implementation of the recently enacted Electricity Law, with the establishment of Electricity Distribution companies and the expansion of pre-paid meters would further strengthen collections and reduce net lending

In Gaza, the PNA had to pay both IEC electricity bills and fuel expenses to the Gaza Generating Electricity Company, which averaged NIS 40 million per month. Beginning in 2010, the Gaza Electricity Distribution Company (GDEC), which so far had appropriated the revenue obtained from electricity bill payments, started remitting about NIS 4 million per month to the PNA. MoF has also put the GEDC on a declining schedule of Treasury payments for fuel: NIS 36 million in January, NIS 32 million in February, NIS 28 million in March and so forth until the GEDC assumes full responsibility for fuel payments towards the end of 2010.

Development expenditures channeled through the PNA Treasury amounted to $ 56 million during Q110 (tables 1 and 2). This is lower than the $ 72 million in Q409, but substantially higher than the $9 million channeled through the Treasury in Q109. There was a slow build up in development spending, mostly on community development projects, starting with $ 3 million in January and rising to $ 32 million in March, which recorded the completion of 1000 community development projects. It is expected that another 1000 projects will be completed by the end of the year.

The recurrent fiscal deficit in Q110 amounted to $ 307 million on a commitment basis (table 1). A simple extrapolation of this deficit for the full year would bring it to $ 1.228 billion, or within the budget appropriation of $ 1.243 billion. In fact, it is expected that some budgetary items such as net lending will decline during the course of the year, while clearance revenues should increase. Thus, budget execution so far appears to be on track with the 2010 deficit target. The deficit on a cash basis was substantially lower, at $ 260 million, mostly due to financing shortfalls (table 3).

Financing of the budget deficit in Q110 from external budget support, amounted to $ 208 million, mostly from the European Commission ($ 106 million) and from the World Bank Trust Fund ($96 million, table 7). However, this external budget

support fell substantially short of the quarterly financing requirement of about $ 300 million. This shortfall has prompted the Treasury to increase its borrowing from the banking system by $ 98 million during the first quarter, even though the PNA had already reached the upper limits of its borrowing capacity from the banking system, under sound prudential criteria applied by lenders. This shortage of liquidity also resulted in some accumulation of expenditure payment arrears ($ 45 million) as well as tax refunds arrears ($ 23 million). Development financing channeled through the Treasury only amounted to $ 2.2 million.